Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-6601-99
AJMandell

date:

to: Acting Chief, Brooklyn Appeals
Attn: Martin Schmeltz, Team Chief

from: District Counsel, Brooklyn

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subject: [redacted]
U.I.L. 172.01-00

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Issue:

1. Whether the net operating loss generated by the taxpayer in the [redacted] year qualifies as a specified liability loss under I.R.C. section 172(f)(1)(B)?

2. If the net operating loss generated by the taxpayer in the [redacted] year qualifies as a specified liability loss, can the taxpayer carry back the loss to a year beginning before January 1, 1984?

Facts:

The facts, as we understand them from the information you provided, are as follows:

[redacted] (hereafter the taxpayer) is a manufacturer of [redacted]. Prior to [redacted], the taxpayer operated a profitable business. The taxpayer claimed tax losses of approximately $[redacted] in [redacted], and large losses were claimed for the taxable years [redacted] through [redacted]. The losses were the result of the taxpayer having to cease production, and initiate a product recall, of certain [redacted]

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[redacted]

The government's investigation disclosed certain product adulterations and record keeping problems with five products manufactured at the taxpayer's [redacted] plant. As a result, the taxpayer was forced to indefinitely cease production of the [redacted] and initiate a product recall.

On [redacted], the taxpayer entered into a plea agreement with the Department of Justice under which it agreed to plead guilty to five counts of [redacted] shipped in interstate commerce and related record keeping violations.

The [redacted] that were recalled or rendered worthless in [redacted] resulted in the $[redacted] loss. Approximately $[redacted] of the loss was carried back to [redacted] and [redacted] under the normal 3 year carryback rules of I.R.C. section 172(b)(1)(A), and the taxpayer received the refunds claimed. At issue is the approximately $[redacted] that was carried back to [redacted] through [redacted] under the 10 year carryback provisions of section 172(f)(1)(B).[1]

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[1]The specified liability portion of the loss was comprised of inventory write-offs of $[redacted] and recall of products of $[redacted]. The District did not challenge the composition or amount of the loss.

The [redacted] more than three years prior to [redacted], but apparently, the [redacted] that created the loss were produced and manufactured less than three years before [redacted].

Discussion:

Issue 1: Whether the net operating loss generated by the taxpayer in the [redacted] year qualifies as a specified liability loss under I.R.C. section 172(f)(1)(B)?

Generally, the net operating loss deduction of section 172 responds to a potential unfairness resulting from the fact that the income tax is generally computed on an annual accounting basis. Without the ability to deduct net operating losses, businesses with fluctuating incomes would lose the benefit of their deductions in taxable years in which expenses exceeded income. As the Supreme Court has stated, the net operating loss provisions were designed to permit a taxpayer to "set off its lean years against its lush years." Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957).

Pursuant to I.R.C. section 172(b)(1)(A), a net operating loss (NOL) arising in a tax year beginning before August 6, 1997, can be carried back to the three years immediately preceding the loss year.[2] Pub. L. No. 105-34, section 1082(a)(1)-(2).

In certain circumstances, depending upon the type of taxpayer or the nature of the loss involved, a different carryback period may apply. Pursuant to I.R.C. section 172(b)(1)(C), in the case of a taxpayer that has a specified liability loss (as defined in subsection (f)) for a taxable year, such specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss.

The portion of section 172 providing a special ten-year carryback for a specified liability loss was initially added by the Deficit Reduction Act of 1984 (DRA). Section 91 of the DRA was the same section that added the economic performance rules of code section 461(h). Thus, it is the Service's position that the operation of section 172(f) should be interpreted in the context of its enactment as part of the overall changes to the code resulting from adopting the economic performance rules. Priv. Ltr. Rul. 199936002 (May 20, 1999). Section 172(f) was not intended to extend the net operating loss carryback period for current operating expenses: rather, it was intended to serve the limited

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[2]For tax years beginning after August 5, 1997, a NOL can be carried back to the two years immediately proceeding the loss year. I.R.C. section 172(b)(1)(A)(i).

purpose of extending the carryback period for those "certain liabilities" deferred under the economic performance rules. H.R. Conf. Rep. No. 98-861, at 871-873 (1984), 1984-3 C.B. 1, 125-127.

Prior to its amendment in section 3004(a) of the Tax and Trade Relief Extension Act of 1998[3], section 172(f)(1)(B), as it applied in the year at issue, treated as a specified liability loss the portion of a NOL generated by:

(A) Any amount allowable as a deduction under section 162 or 165 which is attributable to-

(i) product liability, or

(ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

(B) Any amount [other than product liability expenses and certain expenses related thereto] allowable as a deduction under [Chapter 1 of the Internal Revenue Code] with respect to a liability which arises under a federal or state law or out of any tort of the taxpayer if-

(i) in the case of a liability arising out of a federal or state law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, or

(ii) in the case of a liability arising out of a tort, such liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years

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[3]For NOLs arising in taxable years ending after October 21, 1998, section 3004(a) of the Tax and Trade Relief Extension Act of 1998 defines a specified liability loss as the portion of a NOL generated by certain deductions attributable to product liability and other deductions allowable under Chapter 1 of the Code (except for deductions allowable under section 468(a)(1) or 468A(a)) allowable in satisfaction of a liability arising under a federal or state law requiring the reclamation of land; the decommissioning of a nuclear power plant; the dismantlement of a drilling platform; the remediation of environmental contamination; or a payment under any workers compensation act.

before the beginning of the taxable year.[4]

For this purpose, pursuant to section 172(f)(1), a liability is not taken into account unless the taxpayer used an accrual accounting method throughout the period or periods during which the acts or failures to act giving rise to the liability occurred.[5]

It appears that to date, only the Tax Court has judicially interpreted in any detail the statutory language of section 172(f)(1)(B) as in effect prior to the 1998 amendments. In Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), the petitioners asserted that a portion of a NOL generated by deductions for professional fees incurred to comply with reporting, filing, and disclosure requirements imposed by the Securities and Exchange Act of 1934, professional fees incurred to comply with ERISA reporting requirements, and professional fees incurred in connection with an IRS income tax audit constituted a specified liability loss. The Tax Court held that deduction of the above expenses did not result in a specified liability loss because the liability for the expenses did not arise under a federal or state law within the meaning of section 172(f)(1)(b). The Tax Court gave the following three reasons for its conclusion.

First, the court noted that the federal law cited by the petitioners did not establish the petitioners' liability to pay the amounts at issue. The petitioners' liability did not arise until the services were contracted for and received and the petitioners' choice of the means of compliance, rather than the cited regulatory provisions, determined the nature and amount of their costs. If the petitioners had failed to comply with the auditing and reporting requirements or had not obtained the particular services in issue, their liability would have been in amounts not measured by the value of the services they actually contracted for and received. Id. at 184.

Second, the Court read the legislative history of section 172(f)(1)(B) to suggest that Congress intended the provision to apply only to liabilities the deduction of which the economic performance requirement caused to be deferred. Because the economic performance requirement did not delay petitioners' accrual of the deductions at issue, the court concluded that Congress did not intend the NOLs generated by those deductions to qualify as

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[4]In the taxable year at issue section 172(f)(3) provided a special rule for nuclear power plants. The code section was not changed in 1998 and remains in effect.

[5]We are assuming that the taxpayer used an accrual accounting method throughout the periods at issue in this case.

specified liability losses. Id. at 185-186.

Third, in determining the scope of liabilities arising under either federal or state law within the meaning of section 172(f)(1)(B), the court invoked the statutory construction rule of ejusdem generis[6] and considered the specific types of liabilities referred to in section 172(f): product liability, nuclear decommissioning liabilities[7], and torts. The court concluded that Congress intended the 10-year carryback to apply to a relatively narrow class of liabilities similar to those identified in the statute. The court thought the costs at issue in Sealy were routine costs not like those identified in the statute. Id. at 186.

The Service has expressed agreement with the Tax Court that the meaning of the phrase "liability which arises under a Federal or State law" should be determined by relying on the statutory construction rule of ejusdem generis. Priv. Ltr. Rul. 9840003 (May 29, 1998).

Application of the rule of ejusdem generis requires a determination of the characteristics of the class suggested by the enumerated items. The specific liabilities identified in the statute as qualifying for a 10-year carryback share a distinguishing characteristic. Inherent in the nature of each type of identified liability is an element of substantial delay between the time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability. There is an element of delay in the timing of the deduction that is inherent in the nature of the deduction itself. For example, there is often a substantial time lag between the act of selling a defective product and a deduction for a product liability loss. The delay in the timing of the deduction is inherent in the nature of the loss in that it may be several years after the sale of the product before an injury caused by the product occurs or is discovered. Similarly, a taxpayer's deduction for nuclear decommissioning costs is inherently delayed by the substantial number of years that will expire between the time a nuclear power plant is commissioned and when it is decommissioned.

Another example of when the element of delay is inherent in

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[6]Under the ejusdem generis rule of statutory construction, general words that follow the enumeration of specific classes are construed as applying only to things of the same general class as those enumerated. Priv. Ltr. Rul. 9840003 (May 29, 1998).

[7]As mentioned above, section 172(f)(3) provides a special rule for nuclear powerplants.

the statute itself, and therefore when a specified liability loss is generated, is a miner's obligation to restore land that it disturbs. State and/or federal laws generally require miners to restore the surface of land which they strip mine to a condition comparable to its pre-mined state. A miner's legal obligation to restore arises when the miner disturbs the land, although actual restoration may not occur until some time thereafter. Priv. Ltr. Rul. 199936002 (May 20, 1999).

Further evidencing the narrow class of liabilities that qualify for the 10-year carryback is the Service's position that interest on federal and state tax liabilities and federal and state tax deficiencies are routine costs that do not involve an inherent delay between the time the events giving rise to the liability occur and the time a deduction is claimed for the liability. In the case of interest, economic performance occurs as the interest cost economically accrues. Treas. Reg. section 1.461-4(e). The economic performance rules do not cause a delay between the time the events giving rise to an interest liability occur and the time such interest is an allowable deduction for Federal income tax purposes. Priv. Let. Rul. 9840003 (May 29, 1998); Priv. Let. Rul. 199936002 (May 20, 1999).

The Service's reasoning is that although the deduction for the interest on the underpaid tax will be delayed from the time of its economic accrual until resolution of the contest, such a delay is not part of the inherent nature of the liability. A taxpayer need not underreport its Federal income tax liability.

The legislative history of section 172(f)(1)(B) also establishes that Congress intended the 10-year carryback rule to apply to some, but not all, of the types of liabilities with which Congress was concerned when it enacted the economic performance rules. The Conference Report states that a 10-year carryback is provided for "net operating losses attributable to certain liabilities deferred under these provisions". H.R. Rep. No. 861, 98th Cong., 2d Sess. 872 (1984). Based on the forgoing, it appears that Congress intended to enact a limited exception to the normal 3-year carryback rule for a narrow class of liabilities. Priv. Let. Rul. 9840003 (May 29, 1998).

As discussed above, [redacted] and therefore had to cease production of, and recall, certain [redacted]. This resulted in the NOL carryback at issue. The law violated by the taxpayer is cited as section [redacted]. In contrast to the types of liabilities specified in the statute, which include product liability, nuclear decommissioning liabilities and torts, the costs involved in the manufacture and distribution of the [redacted] at issue are routine costs that do not involve an inherent delay between the

time the events giving rise to the liability occur and the time a deduction is claimed for the liability. Therefore, we do not believe that the loss at issue arises under a federal or state law within the meaning of section 172(f)(1)(B).

The taxpayer has also claimed that this is a liability which arises out of a tort. The House and Senate Reports to the 1984 Act both provide only the same single specific example of a type of deduction that could generate a NOL eligible for the proposed new 10-year carryback. The House Report provides:

> This rule applies in the case of a liability under Federal or State law, if the act (or failure to act) occurs at least 3 years before the beginning of the taxable year; and in the case of a tort liability, if the liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the year. For example, this rule would apply if a taxpayer incurred a tort liability for failure to protect another person from a hazardous substance; such as chemical waste, over an extended period of time.

H.R. Rep. No. 432 (Part 2) 98th Cong., 2d Sess. 1256 (1984).

Congress' use of a single example of limited application to illustrate the scope of section 172(f)(1)(B) demonstrates that Congress viewed this provision as a limited exception to the normal carryback rule, and we do not believe that the liability at issue arose out of a tort within the meaning of section 172(f)(1)(B). Priv. Ltr. Rul. 199922046 (March 5, 1999).

Therefore, the taxpayer's deduction for losses attributable to the ceasing of production and product recalls associated with the [redacted] do not generate a specified liability loss.

Whether a particular liability should be considered a specified liability loss is a developing area of law. Although the legislative history, case law, and private letter rulings have not addressed facts similar to the facts of this case, it is clear that Congress intended the ten-year carryback to apply to only a narrow class of liabilities. For the reasons explained above, we do not believe that the facts of this case warrant the expansion of the narrow application of the statute.

Therefore, under the normal NOL rules, pursuant to section 172(b)(1)(A) the taxpayer should only be permitted to carryback the NOL three years and should be able to carry the loss forward to each of the fifteen taxable years following the taxable year of the

loss.[8]

Issue 2: If the net operating loss generated by the taxpayer in the 1993 year qualifies as a specified liability loss, can the taxpayer carry back the loss to a year beginning before January 1, 1984?

Although we have determined that the loss generated by the taxpayer in the [redacted] year does not qualify as a specified liability loss, for informational purposes, even if the loss did qualify, it could not be carried back to a year beginning before January 1, 1984.

Pursuant to section 11811(b)(2)(B) of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, the portion of any loss that is attributable to a deferred statutory or tort liability may not be carried back to any taxable year beginning before January 1, 1984.

If you have any additional questions, please call the undersigned at (516) 688-1701.

This opinion is based upon the facts set forth herein. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

DONALD SCHWARTZ
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By: _____
ANDREW J. MANDELL
Attorney

[8]Because we have concluded that the loss at issue does not generate a specified liability loss, we do not find it necessary to determine whether the acts that created the liability occurred more than three years before the taxable year at issue.